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Tax Savings for Investors in Real Estate

Real estate investors may take advantage of the following tax benefits:

- Sale of investment property may be taxed as capital gain; *see* ¶5.2.
- Depreciation can provide a source of temporary tax-free income; *see* ¶31.1.
- Rental income can be used to offset passive losses; *see* Chapter 10.
- Tax-free exchanges make it possible to defer tax on exchanges of real estate held for investment; *see* ¶31.4.

Losses on real estate transactions may be subject to the following disadvantages:

- Rental losses may not be deductible from other income such as salary interest and dividends unless you qualify as a real estate professional or for the special $25,000 rental loss allowance; *see* Chapter 10.
- Compromises of mortgage liability may subject you to tax; *see* ¶31.11.

Real Estate Investments

¶31.1 Investing in Real Estate Ventures

A real estate investment should provide a current income return and an appreciation in the value of the original investment. As an additional incentive, a real estate investment may in the early years of the investment return income subject to little or no tax. That may happen when depreciation and other expense deductions reduce taxable income without reducing the amount of cash available for distribution. This tax savings is temporary and limited by the terms and the amount of the mortgage debt on the property. Payments allocated to amortization of mortgage principal reduce the amount of cash available to investors without an offsetting tax deduction. Thus, the amount of tax-free return depends on the extent to which depreciation deductions exceed the amortization payments.

To provide a higher return of tax-free income, at least during the early years of its operations, a venture must obtain a constant payment mortgage that provides for the payment of fixed annual amounts which are allocated to continually decreasing amounts of interest and increasing amounts of amortization payments. Consequently, in the early years, a tax-free return of income is high while the amortization payments are low, but as the amortization payments increase, nontaxable income decreases. When this tax-free return has been substantially reduced, a partnership must refinance the mortgage to reduce the amortization payments and once again increase the tax-free return; *see* Examples 1 and 2 below.

The tax-free return is based on the assumption that the building does not actually depreciate at as fast a rate as the tax depreciation rate. If the building is depreciating physically at a faster rate, the so-called tax-free return on investment does not exist. Distributions to investors (over and above current income return) that are labeled tax-free distributions are, in fact, a return of the investor's own capital.

EXAMPLES

1. A limited partnership of 100 investors owns a building that returns an annual income of $100,000 after a deduction of operating expenses, but before a depreciation deduction of $80,000. Thus, taxable income is $20,000 ($100,000 – $80,000). Assuming that there is no mortgage on the building, all of the $100,000 is available for distribution. (Since the depreciation requires no cash outlay, it does not reduce the cash available for distribution.) Each investor receives $1,000. Taxable income being $20,000, only 20% ($20,000 ÷ $100,000) of the distribution is taxable. Thus, each investor reports as income only $200 of his or her $1,000 distribution; $800 is tax free.
2. Same facts as in Example 1, except that the building is mortgaged, and an annual amortization payment of $40,000 is being made. Consequently, only $60,000 is available for distribution, of which $20,000 is taxable. Each investor receives $600, of which ⅓ ($20,000 ÷ $60,000), or $200, is taxed, and $400 is tax free. In other words, the $60,000 distribution is tax free to the extent that the depreciation deduction of $80,000 exceeds the amortization of $40,000—namely $40,000. If the amortization payment were increased to $50,000, only $30,000 of the distribution would be tax free ($80,000 – $50,000).

The advantages just discussed are available for investments made by you individually or in partnership with other associates. They are also available to investors in limited partnerships. However, before investing in a limited partnership, consider these disadvantages of limited partnerships:

1. Investors in limited partnerships are by law generally treated as receiving passive activity income or loss. Furthermore, as a limited partner, you may not take advantage of the $25,000 rental loss allowance, as you are not considered an "active participant"; *see* ¶10.2. In view of the passive activity rules, if you and others join together to buy rental property, you should not organize as a limited partnership if any losses are anticipated. Limited partnerships are advisable only if income is expected or where two or more investment activities will produce income and loss, which will offset each other.
2. Although limited partnerships are organized to prevent double taxation, which occurs in doing business as a corporation, there may be a danger that the partnership could be taxed as a corporation if its operations resemble those of a corporation.
3. Partnership operations do not provide for the diversification of investments or for the free transfer of individual interests. Investors may find it difficult to sell their interests because of transferability restrictions and a lack of an open market for the sale of their interests. This liquidity problem may be overcome by buying interests sold through public exchanges. However, interests in a publicly traded master limited partnership (MLP) are subject to the passive activity restrictions and in some cases are taxed as corporations; *see* ¶10.11.

Real estate investment trusts (REITs). The tax treatment of real estate investment trusts resembles that of open-end mutual funds. Distributions generally are taxed to the investors in the trust as dividend income. Distributed long-term capital gains are reported by the investors as long-term gains; *see also* ¶4.4. If the trust operates at a loss, the loss may not be passed on to the investors.

REMICs. A real estate mortgage investment company (REMIC) holds a fixed pool of mortgages. Investors are treated as holding a regular or residual interest. A REMIC is not a taxable entity for federal income tax purposes. It is generally treated as a partnership, with the residual interest holders as partners.

Investors with regular REMIC interests are treated as holding debt obligations. Interest income is reported on Form 1099-INT and original issue discount (OID) on Form 1099-OID.

The net income of the REMIC, after payments to regular interest holders, is passed through to the holders of residual interests. On

Schedule E, residual holders report the income or loss reported to them by the REMIC on Schedule Q of Form 1066.

Reviewing an investment offer. Consider the following pointers in reviewing an offering.

1. If the venture is constructing a development, discount projected income which may be eroded by increasing construction costs caused by inflation, material shortages, and labor disputes. Escalating costs not accounted for in long-term construction can jeopardize the project or income prospects. Adequate cash reserves should be available for emergencies.
2. Check the market conditions. Has there been overconstruction in the area? Is the area changing socially and economically?
3. Check the fees of managers. See that they are reasonable for your area. A promoter may conceal the amount of money he or she is drawing from the project. The promoter may be taking a real estate commission by having a commission paid to a company which he or she controls. A reliable promoter should disclose this fact and be willing to collect the commission only after the investors have recovered their capital. Also check the reasonableness of prepaid management fees and loan fees and whether or not the sale of property to the syndicate is from a corporation in which the syndicator has an interest. If there is such a sale, check its terms, price, interest rates, and whether there is any prepaid interest which may conceal a cash profit payout to the syndicator.
4. Check the experience and reliability of the manager.

¶31.2 When a Tenancy in Common Is a Partnership

In a tenancy in common, each tenant owns an undivided share in the property. Upon the death of a co-tenant, his or her interest passes to the heirs, not to the other co-tenants as in a joint tenancy.

Tenants in common may or may not be considered as holding the property in a partnership. The determination of whether they are partners affects whether a partnership return must be filed, whether the involuntary conversion election (¶18.20) and first-year expensing election (¶42.3) must be made by the partnership or the co-tenants, and the deductibility of property taxes beyond a co-tenant's percentage of ownership; *see* ¶16.9.

IRS regulations defining partnerships note that the co-ownership of property which is merely maintained, kept in repair, and rented or leased is not a partnership. If you wish to operate the property as a partnership, you may do so by forming a partnership. Even if you do not formally set up a partnership, the IRS may treat your co-ownership as a partnership if the services or other activity in holding the property is considered a business. Collecting rents or hiring agents to collect rents is not considered a business activity. In one case, tenants were held to be partners where the property had been previously owned by a corporation in which they were stockholders. Upon liquidation, they received interests in the property equal to their former stock interests. As they continued the business of the corporation using the same assets and the same methods of operation, they were treated as being in business as a partnership.

¶31.3 Sales of Subdivided Land—Dealer or Investor?

An investor faces a degree of uncertainty in determining the tax treatment of sales of subdivided realty. In some situations, investor status may be preferred, and in others, dealer status.

Capital gain on sale. Investor status allows capital gain treatment. Capital losses may offset the gains. For capital gain, an investor generally has to show that his or her activities were not those of a dealer but were steps taken in a liquidation of the investment. To convince an IRS agent or a court of investment activity, this type of evidence may present a favorable argument for capital gain treatment:

- The property was bought as an investment, to build a residence, or received as a gift or inheritance.
- No substantial improvements were added to the tract.
- The property was subdivided to liquidate the investment.
- Sales came through unsolicited offers. There was no advertising or agents.
- Sales were infrequent.
- There were no previous activities as a real estate dealer.
- The seller was in a business unrelated to real estate.
- The property was held for a long period of time.
- Sales proceeds were invested in other investment property.

Section 1237 capital gain opportunity. Section 1237 is a limited tax provision that provides a capital gain opportunity for subdivided lots only if arbitrary holding period rules and restrictions on substantial improvements are complied with. For example, the lots must generally be held at least five years before sale unless they were inherited. If the lots were previously held for sale to customers, or if other lots are so held in the year of sale, Section 1237 does not apply. Furthermore, substantial improvements must not have been made to the lots. According to the IRS, a disqualifying substantial improvement is one that increases the value of the property by more than 10%. The IRS considers buildings, hard surface roads, or utilities, such as sewers, water, gas, or electric lines, as substantial improvements.

Installment sales. The distinction between an investor and dealer is significant if land is sold on the installment basis. Investor status is preferable if you want to elect the installment method. Dealers may not elect installment sale treatment; *see* ¶5.25.

Interest expense deductions. The distinction between an investor in land and a dealer is also important in the case of interest expenses. Dealer status is preferable here. Interest expenses incurred by an investor are subject to investment interest deduction limitations; *see* Chapter 15. On the other hand, interest expenses of a dealer in the course of business activities are fully deductible; *see* the Morley Example on the next page.

EXAMPLE

Morley was interested in buying farm acreage to resell at a profit. Two and a half million dollars was set as the purchase price. To swing the deal, Morley borrowed $600,000. A short time later, his attempts to resell the property failed, and he allowed the property to be foreclosed. While he held the property he incurred interest costs of over $400,000, which he deducted. The IRS held the interest was not fully deductible. It claimed the interest was investment interest subject to investment interest restrictions. That is, the debt was incurred to purchase and carry investment property. The IRS position was based on the so-called "one-bite" rule, which holds that a taxpayer who engages in only one venture may not under any circumstances be held to be in a business as to that venture. Morley argued that he bought the property not as an investment property but as business property for immediate resale.

The Tax Court sided with Morley, holding that he held the acreage as ordinary business property. The court rejected the "one-bite" rule. The fact that he had not previously sold business property did not mean that he could not prove that he held acreage for resale. Here, he intended promptly to resell it, and the facts supported his intention.

Passive activity. Income from sales of lots is not considered passive activity income. Thus, losses from sales of land may offset salary and other investment income. If you hold rental property and also sell land, make sure that your accounts distinguish between and separate each type of income. This way income and losses from land sales will not be commingled with rent income subject to the passive activity restrictions of Chapter 10. Your activity in real property development counts towards qualifying you as a real estate professional who may deduct rental losses from nonpassive income if material participation tests are met; *see* ¶10.3.

¶31.4 Exchanging Real Estate Without Tax

You may trade real estate held for investment for other investment real estate and incur no immediate tax. The potential tax on the gain is postponed to the time you sell the new property for more than your basis. A tax-free exchange may also defer a potential tax due on gain from depreciation recapture and might be considered where the depreciable basis of a building has been substantially written off. Here, the building may be exchanged for other property which will give off larger tax deductions.

Fully tax-free exchanges. To transact a fully tax-free exchange, you must satisfy these conditions:

- The property traded must be solely for property of a "like kind." The words *like kind* are liberally interpreted. They refer to the nature or character of the property, not its grade, quality, or use. Some examples of like-kind exchanges are: farm or ranch for city property; unimproved land for improved real estate; rental house for a store building; and fee in business property for 30-year or more leasehold in the same type of property; *see* ¶6.1. You may not make a tax-free exchange of U.S. real estate for real estate in foreign countries.
- The property exchanged must have been held for productive use in your business or for investment and traded for property to be held for productive use in business or investment. Therefore, trades of property used, or to be used, for personal purposes, such as exchanging a residence for rental property, cannot receive tax-free treatment. Special rules, however, apply when you trade your residence for another home; *see* Chapter 29.
- The trade must generally occur within a 180-day period, and property identification must occur within 45 days of the first transfer; *see* ¶6.4 for further details of this test.

A real estate dealer cannot transact a tax-free exchange of property held for sale to customers. Also, an exchange is not tax free if the property received is held for immediate resale.

Tax-free exchanges between related parties are subject to tax if either party disposes of the exchanged property within a two-year period; *see* ¶6.5.

Disadvantage of tax-free exchange. Although the postponement of tax from a tax-free exchange is equivalent to an interest-free loan from the government equal to the amount you would have owed in taxes had you sold the property, this tax advantage is offset by a disadvantage in the case of an exchange of depreciable real estate. You must carry over the basis of the old property to the new property; *see* the following Example.

EXAMPLE

You have property with a basis of $25,000, now valued at $50,000, that you exchange for another property worth $50,000. Your basis for depreciation for the new property is $25,000.

If—instead of making an exchange—you sell the old property and use the proceeds to buy similarly valued property, the tax basis for depreciation is $50,000, giving you larger deductions than you are getting in the exchange transaction. If increased depreciation deductions are desirable, then it may pay to sell the property and purchase new property. Tax may be spread by transacting an installment sale. Project the tax consequences of a sale and an exchange and choose the one giving the greater overall tax benefits. You may find it preferable to sell the property and purchase new property on which MACRS may be claimed.

A tax-free exchange may be advantageous in the case of land. Land is not depreciable, but it may be exchanged for a depreciable rental building. The exchange is tax free and depreciation may be claimed on the building.

A tax-free exchange is not desirable if the transaction will result in a loss, since you may not deduct a loss in a tax-free exchange. To ensure the loss deduction, first sell the property, then buy new property with the proceeds.

Partially tax-free exchanges. Not all property exchanges are tax free. To be completely tax-free, the exchange must be solely an exchange of like-kind properties. If you receive "boot," such as cash or property that is not of like-kind, gain is taxed up to the amount of the boot.

If you trade mortgaged property, the mortgage released is treated as boot; *see* ¶6.3. When there are mortgages on both properties, the mortgages are netted. The party giving up the larger mortgage and getting the smaller mortgage treats the excess as boot. *See* the Example below and also the Example in ¶6.3, which illustrates how to report an exchange on Form 8824.

If the amount of boot exceeds your actual gain, the entire gain is taxed; taxable boot cannot exceed the amount of your gain.

EXAMPLE

You own a small office building with a fair market value of $170,000, and an adjusted basis of $150,000. There is a $130,000 mortgage on the building. You exchange it for Low's building valued at $155,000, having a $120,000 mortgage, and for $5,000 in cash. You compute your gain in this way:

What you received		
Present value of Low's property		$ 155,000
Cash		5,000
Mortgage on building traded		130,000
Total received		$290,000
Less:		
Adjusted basis of building traded	$150,000	
Mortgage assumed by you	120,000	270,000
Actual gain on the exchange		$20,000

However, your actual gain of $20,000 is taxed only up to the amount of boot, $15,000.

Figuring boot		
Cash received		$5,000
Mortgage on building traded	$130,000	
Less: Mortgage assumed on Low's property	120,000	10,000
Gain taxed to the extent of boot		$15,000

¶31.5 Timing Your Real Property Sales

Generally, a taxable transaction occurs in the year in which title or possession to property passes to the buyer. By controlling the year title and possession pass, you may select the year in which to report profit or loss. For example, you intend to sell property this year, but you estimate that reporting the sale next year will incur less in taxes. You can postpone the transfer of title and possession to next year. Alternatively, you can transact an installment sale, giving title and possession this year but delaying the receipt of all or most of the sale proceeds until next year; *see* ¶5.25.

¶31.6 Cancellation of a Lease

Payments received by the tenant on the cancellation of a business lease held long term are treated as proceeds received in a Section 1231 transaction; *see* ¶44.8. Payments received by the tenant on cancellation of a lease on a personal residence or apartment are treated as proceeds of a capital asset transaction. Gain is long-term capital gain if the lease was held long term; losses are not deductible.

Payments received by a landlord from a tenant for canceling a lease or modifying lease terms are reported as rental income when received; *see* ¶9.1.

Cancellation of a distributor's agreement is treated as a sale, if you made a substantial capital investment in the distributorship. For example, you own facilities for storage, transporting, processing, or dealing with the physical product covered by the franchise. If you have an office mainly for clerical work, or where you handle just a small part of the goods covered by the franchise, the cancellation is not treated as a sale. Your gain or loss is ordinary income or loss. If the cancellation is treated as a sale, the sale is subject to Section 1231 treatment; *see* ¶44.8.

¶31.7 Sale of an Option

The tax treatment of the sale of an option depends on the tax classification of the property to which the option relates.

If the option is for the purchase of property that would be a capital asset in your hands, profit on the sale of the option is treated as capital gain. A loss is treated as a capital loss if the property subject to the option was investment property; if the property was personal property, the loss is not deductible. Whether the gain or loss is long term or short term depends on your holding period.

EXAMPLES

1. You pay $500 for an option to purchase a house. After holding the option for five months, you sell the option for $750. Your profit of $250 is short-term capital gain.
2. The same facts as in Example 1 above, except that you sell the option for $300. The loss is not deductible because the option is related to a sale of a personal residence.

If the option is for a "Section 1231 asset" (¶44.8), gain or loss on the sale of the option is combined with other Section 1231 asset transactions to determine if there is capital gain or ordinary loss.

If the option relates to an ordinary income asset in your hands, then gain or loss would be ordinary income or loss.

If you fail to exercise an option and allow it to lapse, the option is considered to have been sold on the expiration date. Gain or loss is computed according to the rules just discussed.

The party granting the option realizes ordinary income on its expiration, regardless of the nature of the underlying property. If the option is exercised, the option payment is added to the selling price of the property when figuring gain or loss.

Note: The treatment of options traded on a public exchange is discussed at ¶30.12.

¶31.8 Granting of an Easement

Granting an easement presents a practical problem of determining whether all or part of the basis of the property is allocable to the easement proceeds. This requires an opinion as to whether the easement affects the entire property or just a part of the property. There is no hard and fast rule to determine whether an easement affects all or part of the property. The issue is factual. For example, an easement for electric lines will generally affect only the area over which the lines are suspended and for which the right of way is granted. In such a case, an allocation may be required; *see* Example 1 below. If the entire property is affected, no allocation is required and the proceeds reduce the basis of the property. If only part of the property is affected, then the proceeds are applied to the cost allocated to the area affected by the easement. If the proceeds exceed the amount allocated to basis, a gain is realized. Capital gain treatment generally applies to grants of easements. The granting of a perpetual easement which requires you to give up all or substantially all of a beneficial use of the area affected by the easement is treated as a sale. The contribution to a government body of a scenic easement in perpetuity is a charitable contribution, not a sale.

In reviewing an easement, the IRS will generally try to find grounds for making an allocation, especially where the allocation will result in a taxable gain. In opposition, a property owner will generally argue that the easement affects the entire property or that it is impossible to make an allocation because of the nature of the easement or the particular nature of the property. If he or she can sustain an argument, the proceeds for granting the easement reduce the basis of the entire property; *see* Examples 1–3 below.

Condemnation. If you realize a gain on a grant of an easement under a condemnation or threat of condemnation, you may defer tax by investing in replacement property; *see* ¶18.18.

EXAMPLES

1. The owner of a 600-acre farm was paid $5,000 by a power company for the right to put up poles and power lines. The right of way covered 20 acres along one boundary which the owner continued to farm. The cost basis of the farm was $60,000, or $100 an acre. The IRS ruled that he had to allocate the basis. At $100 an acre, the allocated basis for the 20 acres was $2,000. Thus, a gain of $3,000 was realized ($5,000 – $2,000).
2. The owner of a tract of unimproved land gave a state highway department a perpetual easement affecting only part of the land. He wanted to treat the payment as a reduction of the basis of the entire tract and so report no gain. The IRS ruled that he had to allocate basis to the portion affected by the road.
3. The owner of farmland gave a transmission company a 50-foot right of way for an underground pipeline that did not interfere with farming. During construction, the right of way was 150 feet. The owner received payments for damages covering loss of rental income during construction and for the 50-foot permanent right of way. The IRS ruled that the damage payment was taxable as ordinary income; the payment for the right of way was a taxable gain to the extent that it exceeded the basis allocated to the acreage within the 50-foot strip.

Release of a restrictive covenant. A payment received for a release of a restrictive covenant is treated as a capital gain if the release involves property held for investment.

EXAMPLE

You sell several acres of land held for investment to a construction company subject to a covenant that restricts construction to residential dwellings. Later, the company wants to erect structures other than individual homes and pays you for the release of the restrictive covenant in the deed. You realize capital gain on receipt of the payment. The restrictive covenant is a property interest and a capital asset in your hands.

¶31.9 Special Tax Credits for Real Estate Investments

To encourage certain real estate investments, the tax law offers the following tax credits—

Low-income housing credit for buildings placed in service after 1986. Qualifying investors are allowed to claim a tax credit in annual installments over 10 years for qualifying newly constructed low-income housing and also to certain existing structures that are substantially rehabilitated. The amount of the credit depends on whether the building is new and whether federal subsidies are received. To claim the credit, you, as the building owner, must receive a certification from an authorized housing credit agency. The agency allocates a credit to you on Form 8609, which you use to claim the credit on Form 8586. You must attach to your return Form 8586, and, in some cases, also Form 8609 and Schedule A, Form 8609.

Rehabilitation credit for pre-1936 buildings or certified historic structures. On Form 3468, you may claim a 10% tax credit for rehabilitating pre-1936 buildings or a 20% credit for rehabilitating certified historic structures. For both types of rehabilitation credits, you must generally incur rehabilitation expenses of $5,000 or your adjusted basis in the building, whichever is greater.

Certified historic structure. A certified historic structure may be used for residential or nonresidential purposes. The National Park

Service must certify that a planned rehabilitation is in keeping with the building's historic status designation for the credit to be available.

In one case, a developer who rehabilitated a certified historic structure and donated a conservation easement to a historic society in the same year was required to base the credit computation on the rehabilitation expenses minus the charitable deduction claimed. If the donation had been made in a later year, a portion of the original credit claimed would be subject to recapture.

Pre-1936 buildings. The 10% credit for pre-1936 buildings applies only to nonresidential property. A substantial portion of the building's original structure must be retained after the rehabilitation. At least 75% of the external walls must be intact, with at least 50% kept as external walls. At least 75% of the existing internal structural framework must be kept in place. In one case, the IRS and Tax Court interpreted the 75% external wall test as requiring that at least 75% of the existing external walls be retained in the same place, thereby denying the credit for a pre-1936 building that was relocated and then renovated. However, a federal appeals court disagreed, holding that there is no relocation restriction; the credit is allowed provided at least 75% of the external walls are retained as such after the renovation.

For further details and credit conditions concerning the two types of rehabilitation credits, *see* Form 3468.

Tax credit limitations. Tax credits for low-income housing and rehabilitating historic or pre-1936 buildings may be limited by passive activity restrictions on Form 8582-CR (Chapter 10) and by tax liability limits for the general business credit (Chapter 40).

Foreclosures and Abandonments of Mortgaged Property

¶31.10 Foreclosures and Voluntary Conveyances to Creditors

If you are unable to meet payments on a debt secured by property, the creditor may foreclose on the property. A foreclosure sale or a voluntary conveyance of the property to the creditor is treated as a sale of the property. If you are personally liable on the debt, and if the value of the property is less than the cancelled debt, you also generally realize ordinary income on the debt cancellation.

Figuring gain or loss. Gain or loss is the difference between your adjusted basis in the property and the amount realized. Determining the amount realized depends on your liability for the debt:

If you are *not* personally liable on the debt, the amount realized includes the full amount of the cancelled debt, regardless of the value of the property.

If you are personally liable, the amount realized includes the portion of the cancelled debt that equals the fair market value of the property. If the fair market value of the property is less than the debt, the foreclosure or voluntary conveyance back to the creditor is treated as two separate transactions:

1. A sale of property. Gain or loss is the difference between adjusted basis and the amount realized, including the cancelled debt up to the fair market value of the property.
2. The receipt of ordinary income upon the cancellation of the debt for less than the face amount of the debt. You generally have cancellation of debt income equal to the excess of the cancelled debt over the fair market value of the property. However, this income may not be taxable, if you come within the exclusion rules of ¶12.9, such as being insolvent at the time of the foreclosure. *See also* ¶31.11 for the exclusion on restructurings of business real property debt.

CAUTION

Form 1099-A Notifies IRS

If your mortgaged property is foreclosed or repossessed, and the bank or other lender reacquires it, or if the lender knows that you have abandoned the property, you should receive from the lender Form 1099-A, which indicates foreclosure proceeds, the amount of your debt, and whether you were personally liable. The IRS may compare its copy of Form 1099-A with your return to check whether you have reported income from the foreclosure or abandonment.

If the lender also cancels your debt of $600 or more, you may instead receive Form 1099-C, on which the information about the foreclosure or repossession will be included.

EXAMPLES

1. Jones could not meet the mortgage payments on a condominium which cost him $85,000. He had paid cash of $20,000 and taken a mortgage loan of $65,000 on which he was personally liable. When the remaining balance of the loan was $62,000, he defaulted, and the bank accepted his voluntary conveyance of the unit, canceling the loan. Similar units at the time were selling for $60,000. On the transaction, Jones incurred a loss of $25,000: the difference between his adjusted basis of $85,000 and the fair market value of the unit of $60,000. The loss is not deductible because the unit was held for personal purposes. Jones also recognizes income on the cancellation of the loan because the amount of the debt exceeded the fair market value of the unit by $2,000. This amount is taxable, unless Jones can show he was insolvent at the time of the transfer to the bank; *see* ¶12.9.

2. Brown invested in a vacant lot. He put down cash of $10,000 and assumed a mortgage of $20,000. When he could not make payments on the mortgage, the bank foreclosed. The net proceeds from the foreclosure sale were $32,000. Brown received $12,000 and realized a capital gain of $2,000 (the difference between his adjusted basis of $30,000 and the amount realized of $32,000). There is no income from cancellation of indebtedness because the debt was less than the value of the property.

Foreclosure proceeds less than outstanding mortgage. Where a foreclosure sale does not cancel the mortgage debt, there is a conflict of opinion on how to compute the amount realized. Take this case:

In 1982, Aizawa bought rental property for $120,000, paying $30,000 down and giving the seller a $90,000 recourse mortgage note, payable in five years. The Aizawas made timely monthly interest payments but failed to pay off the principal at the end of the fifth year. In 1987, the sellers sued and got a judgment of $133,507 for the original principal due of $90,000, attorneys' fees of $25,000, and extra interest charges. Then, at a foreclosure sale, the sellers bought back the property for $72,700. The judgment and foreclosure sale left a deficiency judgment of $60,807.

The Aizawas deducted a $70,898 loss. They claimed the deficiency judgment of $60,807 should be deducted from the mortgage of $90,000, leaving an amount realized of $29,193. The difference between this amount and the $100,091 undepreciated basis of the property gave them a $70,898 loss. The IRS claimed that the amount realized was $90,000, the amount of the mortgage principal, so that the loss was only $10,091 ($100,091 less $90,000).

The Tax Court disagreed with both sides. The court held that the amount realized was the $72,700 proceeds from the foreclosure sale, so that a loss of $27,391 ($100,091 less $72,700) was incurred. The Aizawas' approach is wrong; they reduced the amount realized by the deficiency award they had not paid. The IRS approach is wrong; it included in the amount realized part of the mortgage debt which the Aizawas still owed.

The court recognized that its approach gave the Aizawas an additional loss of $17,300 ($90,000 less $72,700) based on a debt they might not repay. However, this advantage may be eliminated by later events. If they pay off the remaining debt, they may not deduct any additional loss. If they are discharged from paying the balance of the debt, they may be required to report income on the discharge if they are solvent.

Reporting a Foreclosure or Voluntary Conveyance

You report a foreclosure sale or voluntary conveyance to a creditor on Schedule D if the property was held for personal or investment purposes. However, if a gain or loss was realized on a foreclosure (or voluntary reconveyance) of your principal residence, the "sale" is reported on Form 2119.

Foreclosures and reconveyances of business assets are reported on Form 4797.

If income from cancellation of indebtness is realized and it is not excludable under the rules of ¶12.9, you report the taxable amount on Line 21, Form 1040.

¶31.11 Restructuring Mortgage Debt

Rather than foreclose on a mortgage, a lender (mortgagee) may be willing to restructure the mortgage debt by canceling either all or part of the debt. As a borrower (mortgagor), do not overlook the tax consequences of the new debt arrangement. A debt cancellation or reduction is taxable unless it fits within specific exceptions, such as insolvency or bankruptcy. As discussed at ¶12.9, there is no tax if the debt is restructured by the seller of the property or where a debt is reduced by a third-party lender and you are either insolvent, bankrupt, or are a qualifying farmer. These rules apply also to a restructuring of a nonrecourse debt on which you are not personally liable; *see* the Jones Example below, which shows the IRS approach to figuring insolvency upon a debt cancellation.

In the case of partnership property, tax consequences of the restructuring of a third-party loan are determined at the partner level. This means that if you are a partner and are solvent (¶12.9) you may not avoid tax on the transaction, even if the partnership is insolvent.

EXAMPLE

In 1995, Jones borrowed $1,000,000 from Chester and signed a note payable for $1,000,000. Jones was not personally liable on the note, which was secured by an office building valued at $1,000,000 that he bought from Baker with the proceeds of Chester's loan. In 1995, when the value of the building declined to $800,000, Chester agreed to reduce the principal of the loan to $825,000. At the time, Jones held other assets valued at $100,000 and owed another person $50,000. In 1996, Jones realized income of $175,000 on the reduction of the debt, but he can avoid tax to the extent he is insolvent.

To determine the extent of Jones's insolvency, the IRS compares Jones's assets and liabilities immediately before the discharge. According to the IRS, his assets total $900,000: the building valued at $800,000 plus other assets of $100,000. His liabilities total $1,025,000: the debt of $50,000 plus the liability on the note, which the IRS considers to be $975,000, equal to the $800,000 value of the building and the $175,000 discharged debt. The difference between the assets of $900,000 and liabilities of $1,025,000 is $125,000, the amount by which Jones is insolvent. As Jones is insolvent by $125,000, only $50,000 of the $175,000 discharged debt is treated as taxable income.

Restructuring debt on business real estate. A solvent taxpayer may avoid tax on a restructuring of qualifying business real estate debt (¶12.9) by electing to reduce the basis of depreciable real property by the amount of the tax-free debt discharge. The election to reduce basis is made on Form 982.

EXAMPLE

On July 1, 1996, Grant, who is solvent, owns a building worth $150,000 used in his business. It is subject to a first mortgage of $110,000 and a second mortgage of $90,000. Grant's basis in the building is $120,000. The second mortgagee agrees to reduce the second mortgage to $30,000. This results in debt discharge of $60,000 ($90,000–$30,000). The $60,000 is considered debt discharge income. But Grant may elect to exclude $50,000. He reports the remaining $10,000 of discharged debt as taxable income. The exclusion limit is calculated as follows:

2nd mortgage before discharge		$90,000
Less: Fair market value of building	$150,000	
Less: First mortgage	110,000	40,000
Excludable amount		$50,000

On Form 982, Grant may elect to exclude $50,000 from tax because the basis of the building is sufficient to absorb a basis reduction of $50,000.

¶31.12 Abandonments

On an abandonment of business or investment property, you may claim an ordinary loss for the property's adjusted basis (when abandoned) on Form 4797. However, if the abandoned property is later foreclosed or repossessed, you may realize a gain or loss under the rules of ¶31.10 for foreclosures or voluntary conveyances to creditors. For example, if an abandonment loss for mortgaged property is claimed in 1995 but in 1996 the property is foreclosed upon by the lender, all or part of the cancelled debt will be treated as an amount realized by you on a sale in 1996. The amount realized depends on whether you were personally liable and the value of the property. If personally liable, you may also realize ordinary income from cancellation of the debt; *see* ¶31.10.

Abandoning a partnership interest. Where real estate values have sharply declined, partnerships may be holding realty subject to mortgage debt that exceeds the current value of the property. Some investors in such partnerships have claimed that they can abandon their partnership interests and claim abandonment losses. In one case, an investor in a partnership holding land in Houston, Texas, argued that he abandoned his partnership interest by making an abandonment declaration at a meeting of partners, and also declaring that he would make no further payments. He offered his interest to the others, who refused his offer. The IRS held that he failed to prove abandonment of his partnership interest or that the partnership abandoned the land. The Tax Court sided with the IRS, emphasizing his failure to show that the partnership abandoned the land. However, the appeals court for the Fifth Circuit reversed and allowed the abandonment loss. It held that the emphasis should be on the partner's actions, not the actions of the partnership. Although neither state law nor the IRS regulations described how a partnership interest is to be abandoned, the appeals court held that the partner's acts and declaration were sufficient to effect an abandonment of his partnership interest. The appeals court also held that the loss on the partnership interest could have been sustained on the basis of the worthlessness of his interest. The partnership was insolvent beyond hope of rehabilitation: (1) the partnership's only asset was land with a fair market value less than the mortgage debt; (2) the partnership had no source of income; and (3) the partners refused to contribute more funds to keep the partnership afloat.

In a subsequent case, the Tax Court held that a doctor had abandoned a movie production partnership interest when he refused to advance any more money or to participate in the venture because he disapproved of the content of the film being produced and feared it might jeopardize his position at a hospital operated by a religious organization. Also, the limited partners had voted to dissolve.

Note: If, after the year the abandoned loss is claimed, the partnership's mortgaged holdings are foreclosed upon or reconveyed to the lender, each partner's share of the cancelled debt may be treated as an amount realized on a sale, or as ordinary cancellation of debt income; *see* ¶31.10.

¶31.13 Seller's Repossession After Buyer's Default on Mortgage

When you, as a seller, repossess realty on the buyer's default of a debt which the realty secures, you may realize gain or loss. (If the realty was a personal residence, the loss is not deductible.) A debt is secured by real property whenever you have the right to take title or possession or both in the event the buyer defaults on his or her obligation under the contract.

Figuring gain on the repossession. Gain on the repossession is the excess of: (1) payments received on the original sales contract prior to and on the repossession, including payments made by the buyer for your benefit to another party; *over* (2) the amount of taxable gain previously reported prior to the repossession.

Gain computed under these two steps may not be fully taxable. Taxable gain is limited to the amount of original profit less gain on the sale already reported as income for periods prior to the repossession and less your repossession costs.

The limitation on gain does not apply if the selling price cannot be computed at the time of sale as, for example, where the selling price is stated as a percentage of the profits to be realized from the development of the property sold.

EXAMPLE

Assume you sell land for $25,000. You take a $5,000 down payment plus a $20,000 mortgage, secured by the property, from the buyer, with principal payable at the rate of $4,000 annually. The adjusted basis of the land was $20,000 and you elected to report the transaction on the installment basis. Your gross profit percentage is 20% ($5,000 profit over $25,000 selling price). In the year of sale, you include $1,000 in your income on the installment basis (20% of $5,000 down payment). The next year you reported profit

of $800 (20% of $4,000 annual installment). In the third year, the buyer defaults, and you repossess the property. The amount of gain on repossession is computed as follows:

1. Compute gain:		
Amount of money received ($5,000 *plus* $4,000)		$9,000
Less: Amount of gain taxed in prior years ($1,000 *plus* $800)		1,800
Gain		$7,200
2. Compute limit on taxable gain, assuming cost of repossession is $500:		
Original profit		$5,000
Less:		
Gain reported as income	$1,800	
Cost of repossession	500	2,300
Taxable gain on repossession		$2,700

These rules do not affect the character of the gain. Thus, if you repossess property as a dealer, the gain is subject to ordinary income rates. If you, as an investor, repossess a tract originally held long term whose gain was reported on the installment method, the gain is capital gain.

The basis of repossessed property. It is the adjusted basis of the debt (face value of the debt less the unreported profits) secured by the property, figured as of the date of repossession, increased by (1) the taxable gain on repossession, *and* (2) the legal fees and other repossession costs you paid.

EXAMPLE

Same facts as in the previous Example. The basis of the repossessed property is computed as follows:

1. Face value of debt ($20,000 note *less* $4,000 payment)		$16,000
2. *Less:* Unreported profit (20% of the $16,000 still due on the note)		3,200
3. Adjusted basis at date of repossession		$12,800
4. *Plus:* Gain on repossession	$2,700	
Cost of repossession	500	3,200
5. Basis of repossessed property		$16,000

If you treated the debt as having become worthless or partially worthless before repossession, you are considered to receive, upon the repossession of the property securing the debt, an amount equal to the amount of the debt treated as worthless. You report as income the amount of any prior bad debt deduction and increase the basis of the debt by an amount equal to the amount reported as income.

If your debt is not fully discharged as a result of the repossession, the basis of the undischarged debt is zero. No loss may be claimed if the obligations subsequently become worthless. This rule applies to undischarged debts on the original obligation of the purchaser, a substituted obligation of the purchaser, a deficiency judgment entered in a court of law into which the purchaser's obligation was merged, and any other obligations arising from the transaction.

The repossession rules do not apply if you repurchase the property by paying the buyer a sum in addition to the discharge of the debt, unless the repurchase and payment was provided for in the original sale contract, or the buyer has defaulted on his or her obligation, or default is imminent.

Personal residence. Special rules apply to repossessions and resales of a personal residence if: (1) at least some of the gain on the original sale was not taxed because you made an election to avoid tax (¶29.14) or you defer gain on the purchase of a new residence (¶29.2); and (2) within a year after the repossession you resell the property.

The original sale and resale is treated as one transaction. You refigure the amount realized on the sale. You combine the selling price of the resale with the selling price of the original sale. From this total, you subtract selling expenses for both sales, the part of the original installment obligation that remains unpaid at the time of repossession, and repossession costs. The net is the amount realized on the combined sale-resale. Subtracting basis in the home from the amount realized gives the gain on the combined sale-resale before taking into account the exclusion (¶29.14) or deferral (¶29.2) rules.

EXAMPLE

In 1995, you, at age 60, sell a house for $250,000. You received $50,000 cash and took back a purchase money mortgage of $200,000. Selling expenses were $3,000; the adjusted basis of the house was $167,000. You realized a profit of $80,000:

Amount realized ($250,000 – $3,000)	$247,000
Less: Adjusted basis	167,000
Gain	$ 80,000

You elected to avoid tax by claiming the exclusion of ¶29.14.

In 1996, the buyer defaulted and you repossessed the house and sold it for $300,000, incurring selling expenses of $5,000 and repossession costs of $2,000. The buyer still owed you $200,000 on his installment note. You have a $48,000 taxable gain on the combined sale-resale as follows:

Selling price on resale		$300,000
Selling price on original sale		250,000
Total selling price		$550,000
Less:		
Unpaid buyer's note	$200,000	
Repossession costs	2,000	
Combined selling expenses ($3,000 + $5,000)	8,000	210,000
Amount realized		$340,000
Less: basis		167,000
Gain on sale-resale		$173,000
Less: $125,000 exclusion		125,000
Taxable gain		$ 48,000

¶31.14 Foreclosure on Mortgages Other Than Purchase Money

If you, as a mortgagee (lender), bid in on a foreclosure sale to pay off a mortgage that is *not a purchase money mortgage*, your actual financial loss is the difference between the unpaid mortgage debt and the value of the property. For tax purposes, however, you may realize a capital gain or loss and a bad debt loss which are reportable *in the year of the foreclosure sale*.

Your bid is treated as consisting of two distinct transactions:

1. The repayment of your loan. To determine whether this results in a bad debt, the bid price is matched against the face amount of the mortgage.
2. A taxable exchange of your mortgage note for the foreclosed property, which may result in a capital gain or loss. This is determined by matching the bid price against the fair market value of the property.

EXAMPLES

1. *Mortgagee's bid less than market value.* You hold a $40,000 mortgage on property having a fair market value of $30,000. You bid on the property at the foreclosure sale at $28,000. The expenses of the sale are $2,000, reducing the bid price to $26,000. The mortgagor is insolvent, so you have a bad debt loss of $14,000 ($40,000 – $26,000). You also have a $4,000 capital gain (the fair market value of the property of $30,000 – $26,000).
2. *Mortgagee's bid equal to market value.* Suppose your bid was $32,000, and had $2,000 in expenses. The difference between the net bid price of $30,000 and the mortgage of $40,000 is $10,000. As the mortgagor is insolvent, there is a bad debt loss of $10,000. Since the net bid price equals the fair market value, there is neither capital gain nor loss.
3. *Mortgagee's bid greater than market value.* Suppose your bid was $36,000 and had $2,000 in expenses. Your bad debt deduction is $6,000—the difference between the mortgage debt of $40,000 and the net bid price of $34,000. You also had a capital loss of $4,000 (the difference between the net bid price of $34,000 and the fair market value of $30,000).

Where the bid price equals the mortgage debt plus unreported but accrued interest, you report the interest as income. But where the accrued interest has been reported, the unpaid amount is added to the collection expenses.

Preserve evidence of the property's fair market value. At a later date, the IRS may claim that the property was worth more than your bid and may tax you for the difference. Furthermore, be prepared to prove the worthlessness of the debt in order to support the bad debt deduction.

Voluntary conveyance. Instead of forcing you to foreclose, the mortgagor may voluntarily convey the property to you in consideration for your canceling the mortgage debt. Your loss is the amount by which the mortgage debt plus accrued interest exceeds the fair market value of the property. If, however, the fair market value exceeds the mortgage debt plus accrued interest, the difference is taxable gain. The gain or loss is reportable in the year you receive the property. Your basis in the property is its fair market value when you receive it.

¶31.15 Foreclosure Sale to Third Party

When a third party buys the property in a foreclosure, the mortgagee receives the purchase price to apply against the mortgage debt. If it is less than the debt, the mortgagee may proceed against the mortgagor for the difference. Foreclosure expenses are treated as offsets against the foreclosure proceeds and increase the bad debt loss.

You deduct your loss as a bad debt. The law distinguishes between two types of bad debt deductions: business bad debts and nonbusiness bad debts. A business bad debt is fully deductible. A nonbusiness bad debt is a short-term capital loss that can be offset only against capital gains, plus a limited amount of ordinary income (¶5.9). In addition, you may deduct a partially worthless business bad debt, but you may not deduct a partially worthless nonbusiness bad debt. Remember this distinction if you are thinking of forgiving part of the mortgage debt as a settlement. If the debt is a nonbusiness bad debt, you will not be able to take a deduction until the entire debt proves to be worthless. But whether you are deducting a business or a nonbusiness bad debt, your deduction will be allowed only if you show the debt to be uncollectible—for example, because a deficiency judgment is worthless or because the mortgagor is declared bankrupt.

EXAMPLE

You hold a $30,000 note and mortgage which are in default. You foreclose, and a third party buys the property for $20,000. Foreclosure expenses amount to $2,000. The deficiency is uncollectible. Your $12,000 loss is figured as follows:

Unpaid mortgage debt		$30,000
Foreclosure proceeds	$20,000	
Less: Expenses	2,000	
Net proceeds		18,000
Bad debt loss		$12,000

¶31.16 Transferring Mortgaged Realty

Mortgaging realty that has appreciated in value is one way of realizing cash on the appreciation without current tax consequences. The receipt of cash by mortgaging the property is not taxed; tax will generally be imposed only when the property is sold. However, there is a possible tax where the mortgage exceeds the adjusted basis of the property and the property is given away or transferred to a controlled corporation. Where the property is transferred to a controlled corporation, the excess is taxable gain. Further, if the IRS successfully charges that the transfer is part of a tax avoidance scheme, the taxable gain may be as high as the amount of the mortgage liability.

Gifts. The IRS holds that a gift of mortgaged property results in taxable income to the donor to the extent that the mortgage liability exceeds the donor's basis.